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May 16, 1997

Mr. William F. Caton
Acting Secretary
Federal Communications Commission
1919 M Street, N.W.
Room 222
Washington, D.C. 20554

Re: Implementation of Local Competition Provisions of the Telecommunications Act of 1996, CC Docket No. 96-98

Dear Mr. Caton:

Robert B. McKenna of U S WEST, Inc. and the undersigned met today with Robert M. Pepper, Elliott E. Maxwell, and Gregory L. Rosston of the Office of Plans and Policy to discuss the effects of Commission policies on incentives for innovation and investment in telecommunications infrastructure. The issues discussed included issues involved in the pending reconsideration of the First Report and Order in the above proceeding. The views expressed on behalf of U S WEST are summarized in the attached paper.

Please contact me if you have any questions.

Sincerely,

William T. Lake

William T. Lake

Enclosures

cc: Robert Pepper
Elliott Maxwell
Gregory Rosston

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CREATING PROPER INCENTIVES FOR INFRASTRUCTURE INVESTMENT

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I. Guiding Principles

- In enacting the 1996 Act, Congress concluded that local telephone service is no longer a natural monopoly and should be opened to competition. This means that market forces should result over time in the emergence of service providers with competing alternative networks, each with a strong incentive to win customers through technological innovation and investment in new facilities. In the meantime, the Commission should ensure that measures designed to spur competition in the short term do not artificially impede progress toward the long-term goal of full facilities-based competition.

- The competitive marketplace is the best arbiter of what constitutes an economically efficient investment decision. Therefore:

  - First and foremost, the Commission should rely on the marketplace, rather than regulatory requirements, wherever possible to supply the facilities and services that new competitors ("CLECs") need to enter the local telecommunications market. If the market for a facility or service is sufficiently competitive, an incumbent carrier ("ILEC") should be able to decide how to exploit its investments in that market, including the terms on which the ILEC may make its facilities or services available to others, based on market considerations rather than regulation. The Commission should regulate access to such ILEC resources only where necessary -- namely, where competition does not make them available.

    - "Bottleneck" facilities -- that is, facilities that are essential to the ability to compete in the provision of telecommunications services and cannot be duplicated by CLECs within a reasonable time frame -- may be suitable candidates for regulated unbundling.
    - Any resource that is not a bottleneck -- because substitutes exist or can be created by competitors within a reasonable time frame -- is subject to competitive discipline. Requiring unbundling on prescribed terms is therefore unnecessary and should be avoided.

  - Second, where the Commission finds that a facility constitutes a bottleneck and decides to regulate its provision by ILECs, the Commission's regulatory scheme should replicate as closely as possible the incentive structure that a competitive marketplace would produce.

- The Commission should set regulated prices with reference to the same standards and considerations that govern business pricing in a competitive environment.
- The Commission should ensure that its pricing rules do not inefficiently distort the investment incentives of ILECs and CLECs.
  - If regulated prices artificially restrict an ILEC's opportunity to reap the rewards of innovation and infrastructure investment, then the ILEC will have inadequate incentives to upgrade its network.
  - If regulated prices allow CLECs to use an ILEC's network on artificially favorable terms, then CLECs will have inefficiently low incentives to invest in network facilities of their own.

II. <u>Specific Issues of Concern</u>

1. Scope of Unbundling Now Required by Commission

a. <u>Impact on ILEC Incentives</u>

- Requiring ILECs to provide their resources to competitors on an unbundled basis reduces their incentives to innovate and invest in infrastructure, leading them to forego efficient investment opportunities.
  - In a competitive marketplace, a firm invests in new facilities in order to differentiate its services from those of other firms or otherwise to obtain a short-term competitive advantage over its rivals. An ILEC's incentive to make efficiency-enhancing investments is reduced if it must immediately unbundle the resulting facilities and turn them over to its competitors at regulated prices. An ILEC contemplating such an investment knows that it has no prospect of using its innovation to differentiate its services from those of its competitors, and that those competitors stand to benefit from the investment as much as the ILEC itself does.

b. <u>Impact on CLEC Incentives</u>

- By permitting CLECs to obtain virtually any of an ILEC's resources on an unbundled basis at regulated prices, the Commission's rules artificially encourage

CLECs to avoid the risks of investing in their own facilities by relying on the ILECs' facilities instead. The result is inefficient underinvestment by CLECs.

- A regime under which unbundling requirements extended only to bottleneck facilities would provide economically efficient incentives for CLECs to invest in infrastructure. A CLEC would have to offer service via a combination regulated bottleneck facilities and facilities that the CLEC can obtain in the marketplace or construct itself.
- Because Commission rules enable a CLEC to obtain virtually all elements of an ILEC's business (including related support systems) on an unbundled basis at regulated prices, the CLEC has artificially reduced incentives to bear the risks of investing in facilities of its own. Relying on the ILEC's facilities avoids the risk of financial loss if facilities become obsolete or otherwise prove unprofitable.
- Broad unbundling requirements also eliminate a CLEC's incentive to invest in new facilities to defend itself competitively against efficiency-enhancing investments by the ILEC. The CLEC knows that, even if the ILEC does make an efficiency-enhancing investment, the CLEC can appropriate the benefits of that investment for itself by taking the new facilities from the ILEC as unbundled elements at regulated prices. Therefore, the CLEC lacks the incentive that it would have in a competitive marketplace to invest in order to keep abreast of ILEC improvements.

- Requiring ILECs to provide CLECs customized network elements, superior to what the ILECs currently provide their own customers, further reduces the incentive of CLECs to invest in facilities themselves.
    - Under normal competitive circumstances, the desire to have facilities offering additional capabilities or greater efficiency would be an important factor motivating CLECs to make investments in infrastructure. However, to the extent that the Commission's rules require ILECs to provide upgraded facilities to a CLEC on demand, that CLEC could obtain the features it desires without the risks entailed in constructing facilities of its own. If an attempted innovation fails to function as hoped or presents unanticipated technical complications, the CLEC can walk away from the venture unscathed, leaving the ILEC to bear the costs of the failed investment. This further skews the CLEC's incentives away from a facilities-based business strategy and towards a strategy based on repackaging elements of the ILEC's existing network.

c. Recommendations

- The Commission should limit unbundling requirements to ILEC facilities that are bottlenecks. Applying unbundling requirements only to bottleneck facilities would leave intact ILECs' normal market incentives to make economically efficient investments in all other resources.
  - In general, the Commission should consider as bottlenecks only those facilities that are essential to the ability to compete and that competitors cannot practically duplicate within a reasonable time frame.
    - Where CLECs can obtain substitute facilities in the marketplace or reasonably can construct them, unbundling requirements serve no economic purpose and needlessly distort investment incentives.
    - The distorted incentives that unbundling requirements cause may be justified only where regulated unbundling is essential to the development of competition in the first place .
  - The Commission should adopt a strong presumption that any facility yet to be built is not a bottleneck. Given the new regime of guaranteed interconnection, any carrier can construct facilities as an overlay to the existing network. Therefore, a facility an ILEC may decide to build in the future could just as easily be built by a CLEC. As a result, there is no reason to treat an ILEC's new infrastructure investments as bottleneck facilities.

- If the Commission nevertheless applies unbundling requirements to some non-bottleneck facilities, it should at a minimum provide that newly constructed facilities will not be subject to those requirements immediately upon completion. Exempting newly completed facilities from unbundling rules for a certain portion of the facilities' expected useful life would give the investing ILEC a temporary opportunity to reap commercial gains from its investment, and hence would preserve at least some of the ILEC's incentive to invest and innovate.

- The Commission should not require that ILECs provide CLECs customized network elements, of superior quality to what the ILECs currently provide to their own customers. If the Commission does so require, it should:
  - Clarify that ILECs must provide customized network elements to CLECs only to the extent that it is technically feasible to improve the quality of an ILEC's existing bottleneck facilities. ILECs should not be required to build new facilities in response to CLEC requests for network elements of a higher quality; and

- Ensure that the CLEC bears the risks associated with a customized investment. For example, the Commission could require a CLEC that requests an upgrade to pay up front the cost of construction of the upgrade. Alternatively, the Commission could require the CLEC to agree to use the upgraded facilities for the expected life of the equipment, with penalties for earlier termination. Such requirements would eliminate a CLEC's ability to walk away from unsuccessful investments that it caused to be made. Moreover, forcing the CLEC to bear the investment risks would eliminate the regulatorily created advantage to the CLEC of relying on ILEC facilities to avoid normal business risks -- an advantage that inefficiently depresses a CLEC's incentive to invest in alternative infrastructure.

2. Pricing Rules for Interconnection and Unbundled Elements

a. <u>Impact on ILEC Incentives</u>

- Requiring an ILEC to make any innovative facilities it constructs available to its competitors at the equilibrium price (TELRIC) artificially curtails the ILEC's incentive to make efficiency-enhancing investments. In a dynamic market, investments are made by competitors seeking the ability to price above the equilibrium price on a short-term basis. Where ILECs must price their innovations at equilibrium from the outset, they have no incentive to innovate.

- Basing TELRIC calculations on a theoretical network constructed with the most efficient, up-to-the-minute technology virtually ensures that an ILEC will not be able to recover the actual costs of any infrastructure investment it chooses to make, and thus creates an artificial disincentive to invest.
  - With prices based on a hypothetical network employing ideally efficient technology, each subsequent technological advance in the marketplace will force the ILEC to reduce prices <u>immediately</u> to reflect the potential cost reduction -- even though the new technology is not yet incorporated into any existing network in the ILEC's service area. In a normal competitive environment, further technological advances drive down prices <u>over time</u>, as competitors implement a more efficient technology and begin pricing accordingly. An investor has an opportunity to attempt to recover the cost of an investment before further technological advances generate market-driven price reductions that preclude continued cost recovery. By causing such price reductions to be immediate rather than

gradual, the Commission's pricing rules virtually eliminate that opportunity.

- The Commission has not adequately specified that prices must reflect the risks of investment -- that is, that states must allow ILECs to recover through successful investments the costs of the ILECs' entire relevant portfolio of investments, including unsuccessful ones . Therefore, the Commission's TELRIC formula fails to guarantee that ILECs will have efficient investment incentives.
    - Investing in new facilities entails risks that the facilities may be less technically or economically successful than anticipated. Taking on such risks makes sense only if successful investments together will produce revenues sufficient to cover the actual costs of those investments <u>plus</u> a risk premium that is sufficient to cover the aggregate costs of all reasonably incurred investments -- successful and unsuccessful -- in the ILEC's portfolio. The Commission has suggested that TELRIC will reflect investment risk through the risk-adjusted cost of capital, but has not expressly directed states to calculate this element of costs on a portfolio-wide basis.

b. <u>Impact on CLEC Incentives</u>

- By giving CLECs a guaranteed right to use the incumbents' facilities at the incremental cost of the best, up-to-the-minute technologies, the Commission's pricing rules artificially diminish the incentives for CLECs to invest in new facilities.
    - Pricing based on the ideally efficient network enables CLECs to take advantage of technological advances without actually building facilities that exploit those advances. Instead of constructing more efficient facilities and then using the cost advantage to undercut the ILEC's price, the CLEC may simply demand that the ILEC make its existing facilities available at prices that fully reflect the latest technological advance. The CLEC reaps the cost savings associated with the advance even if the efficient facilities never are built. Since the CLEC also avoids the risks entailed in infrastructure investment, a CLEC would not elect to exploit a technological advance by actually investing in facilities.

c. <u>Recommendations</u>

- The scope of any TELRIC pricing rules, like that of the unbundling requirement, should be narrowed to encompass only bottleneck facilities. ILECs should be free to price nonbottleneck facilities based on conditions in the competitive marketplace. As noted above, the Commission should treat yet-to-be-built facilities as presumptively nonbottleneck.

- The Commission should modify TELRIC so that it is based on an ILEC's actual facilities rather than on hypothetical, ideally efficient network technology. If the Commission does not abandon the hypothetical-facilities approach for all bottleneck facilities subject to TELRIC prices, it should at least do so for any yet-to-be-built facilities that are found to qualify as bottlenecks.

- If the Commission does find that any yet-to-be-built facility is a bottleneck, the agency should clarify that the TELRIC formula requires that the price for that facility include an allowance for risk sufficient to recover an appropriate share of the costs of the unsuccessful investments in the ILEC's investment portfolio. Alternatively, the Commission could mandate that TELRIC calculations for each individual investment include a risk premium reflecting the particular risk level of that investment. Either approach would preserve the ILECs' investment incentives by enabling investments that are successful to make up for those that are not.